Capital Market Review

Third Quarter, 2014

Executive Summary
The U.S. economy has been operating in a consistent, low-growth mode for years. We see no reason why this scenario would change. Consumer and employment are doing fine. Inflation is tame. Employers would like to hire more, but there is a skills gap. This may put future pressure on wages. Housing market should be doing better but banks remain reluctant to lend.

U.S. Federal Reserve is starting toward the path of interest rate normalization. Most believe first interest rate hike occurs in 2015. Subsequent hikes will likely be gradual and probably take 2-3 years to reach a normalized interest rate level.

Worldwide economic growth is a big disappointment. Another European recession is not out of the question. Policymakers are starting another round of stimulative policies. Political conficts/instability appear to be widespread.

Given this backdrop, U.S. stock and bond returns have exhibited modest, but positive returns year-to-date.

JIC recommends investors maintain modest future return expectations.

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Economic Conditions

The U.S. economy appears to be in a consistent lower-growth mode. It is hard to imagine 4% or 5% economic growth for any sustained period of time. In short, 2% to 2.5% economic growth now seems to be the expectation. Perhaps we can get to 3% on the high end.

Consumer spending is relatively stable (and growing), and the employment picture has improved. The unemployment rate continues to decline and employers appear willing to hire if they could find qualified candidates. Wages are rising consistent with inflation, but we may soon see more upward pressure.

By now, the expectation is that the housing market would be operating on "all cylinders", but that has not occurred. In some parts of the country affordability is an issue but, more importantly, banks remain tightfisted in providing credit. To highlight the point, the news media recently reported that Ben Bernanke (the former Fed Chairman), could not refinance his mortgage.

During the past year, the Federal Reserve started to scale back its quantitative easing program (i.e. bond buying) and it will probably be stopped by the end of this year. While the Fed is starting toward the path of interest-rate policy normalization, there does not appear to be any consensus when changes to short-term interest rates would occur.

The Fed has made it very clear they will be data driven. Most observers believe the initial rate hike will occur sometime next year. This economy has had so many "fits and starts", we suspect the FED, once interest rate hikes begin, will be gradual with follow-up hikes (assuming inflation remains tame). We expect it may take 2-3 years before short-term rates will approach a "normalized" level.

Worldwide economic growth, particularly in the Eurozone, has been a significant disappointment. In fact, Europe has not shown any growth in the recent quarter. China's growth seems to have peaked and Japan's economic growth has been affected by the tax hike that occurred earlier this year.

2015 will likely be the year in which we see a decoupling of economic policy. The U.S. (and probably the U.K.) may start increasing interest rates, but the European Central Bank may not only further reduce interest rates but is seeking other non-traditional policies to stimulate their economies.

Significant geopolitical concerns may also be dampening economic growth. The conflict between Ukraine and Russia continues, the ongoing conflict in the Middle East, most notably in Iraq and Syria, the uncertainty surrounding the vote for Scottish independence (ultimately unsuccessful), and the selective default on Argentinian debt reminds us that the world remains a dangerous place and upheavals can have economic consequences.

Stock Market

Given this backdrop, it is remarkable how well the U.S. equity markets have held up. While volatility spiked during October, recent rallies have recovered most of the losses that occurred earlier in the month.

The broad U.S. stock market (as measured by the Russell 3000) was flat for the third quarter, but has a year-to-date return (through September 30) of 6.9%. However, that masks some of the performance differences between company size segments. For example, small stocks returned -7.4% during the third quarter and -4.4% YTD. Mid-cap stocks also had a difficult third quarter returning -1.7%, but have performed similar to large stocks on a YTD basis.

There has been little performance difference between investment approach segments (value, core, and growth) on a YTD basis.

Year-to-date, Healthcare, Technology, and Utilities have been the best performing sectors with returns between 13.9% and 16.6%. Sector laggards have been Consumer Discretionary, Energy, and Industrials -- clearly sectors that are more economically sensitive. These sectors have returned between 0.9% and 3.2% on a YTD basis.

International stocks -- both developed as well as emerging markets -- have lagged U.S. stock market returns. Developed international returned -5.9% during the third quarter and -1.4% YTD. Emerging markets third quarter return was -4.3% and their YTD return is 0.3%.

At current valuation levels, JIC recommends investors keep their long-term stock market return expectations modest. We know dividend yields are around 2%, and that valuation levels are at or above their historical averages. However, above average valuation levels can last for many years -- particularly given low the level of long-term interest rates. In short, we would not count on higher multiples to drive future stock returns. Perhaps the best case scenario would be "static" valuation multiples (as opposed to declining).

Higher-than-expected earnings growth would likely benefit future stock returns. This is possible, particularly if worldwide economic growth improves above current expectations.

Stock investors should expect a level of return volatility and, generally speaking, their holding period needs to be well over five years to recover from any future stock market declines that will inevitably occur. Even with stocks at their current level, we expect that over any reasonable length of time, stocks will outperform bonds.

Bond Market

Investment grade bond returns were poor during 2013 (negative) as interest rates rose. Consensus expectations were that interest rates would probably continue to rise during 2014. The consensus has been proven wrong as interest rates have declined across most maturity segments. Recent stock market volatility further lowered yields. At present, 10-year Treasury yields are around 2.4%.

Given the decline in yields, it is not surprising that bond returns have been pretty competitive this year -- and much higher than their yield would suggest. U.S. bonds returned 4.1% YTD while developed and emerging market bonds have returned 0.3% and 8.0%. The rising dollar clearly impacted developed market bond returns.

Corporate bonds have, once again, been the best performing sector returning 5.7% compared to the mortgage-backed bond return of 4.2% and government bond return of 3.0%. For the first time in several years, high yield bond returns (3.5% YTD) have underperformed investment grade bonds.

Bond yields remain extremely low -- hardly providing any return above inflation. AAA corporates currently yield 2.68% while BBB corporates (the last tier of investment grade) yield 3.63%. Today's investment grade bond buyers should probably have a one- or two-year total return expectation between the 2.5% to 3.5% range -- and it stands to reason if interest rates rise -- total returns could be lower.

Summary

The good news is that the U.S. economy is clearly one of the strongest major worldwide economies. The bad news is that, while growing, it is at best moderate growth. We do not foresee major changes to U.S. economic growth -- we simply think it will remain modest. Developed international markets will hopefully start to show some economic improvement, but we suspect that will not be showing up in the data for another year or more.

We suggest investors keep modest future return expectations -- for both stocks and bonds.

Stock Returns For Periods Ending September 30, 2014

	Qtr	Ytd	1 Year	3 Year	5 Year		Qtr	1 Year	3 Year
Nationality						**Developed Country**			
U.S. Market	0.0	7.0	17.8	23.1	15.8	U.S.	0.0	17.8	23.1
Developed Intl	-5.9	-1.4	4.3	13.6	6.6	Canada	9.3	23.6	0.4
Emerging Market	-4.3	0.3	1.8	4.5	1.9				
Size						Europe	-7.0	5.8	15.5
Large	1.1	8.3	19.7	23.0	15.7	France	-0.1	25.1	1.6
Mid	-1.7	6.9	15.8	23.8	17.2	Germany	-0.2	26.8	4.6
Small	-7.4	-4.4	3.9	21.3	14.3	Italy	-1.7	48.0	-1.3
Micro	-7.3	-4.7	6.8	27.5	16.6	United Kingdom	5.0	22.1	6.0
Approach						Pacific	-3.6	0.9	10.3
Value	-0.9	7.0	17.7	23.7	15.1	Australia	1.8	15.6	1.1
Core	0.0	7.0	17.8	23.1	15.8	Hong Kong	6.7	14.3	5.0
Growth	0.9	6.9	17.9	22.4	16.4	Japan	6.5	8.0	4.8
Sector						**Emerging Market**			
Cons Discretionary	0.3	0.9	11.8	26.3	21.5	China	3.5	12.7	-2.3
Cons Staples	2.0	7.2	16.5	18.2	15.4	India	12.1	25.6	-0.8
Energy	-8.6	3.2	11.9	16.9	12.5	Korea	6.4	23.3	1.1
Finance	2.3	7.4	18.5	27.6	11.0	Czech Republic	0.1	21.0	-13.0
Healthcare	5.5	16.6	28.4	28.8	19.7	Hungary	1.5	-17.4	-17.7
Industrials	-1.1	2.9	16.8	24.8	17.3	Poland	-2.2	19.2	-6.6
Technology	4.8	14.1	29.3	22.3	16.0	Russia	9.8	6.4	-10.2
Materials	0.2	8.9	20.5	22.0	13.2	Brazil	5.7	8.8	-13.0
Telecomm	3.1	7.5	13.3	15.2	14.0	Mexico	6.2	5.7	3.2
Utilities	-4.0	13.9	17.1	12.3	12.1				

Stock Fundamentals As Of September 30, 2014

	United States		Developed		Emerging	
	Current	1 Year Ago	Current	1 Year Ago	Current	1 Year Ago
Price/Earnings Current	18.7	17.3	15.9	15.2	12.8	11.2
Price/Forecast Earnings	17.4	15.8	15.1	14.1	12.0	11.0
Price/Book	2.6	2.4	1.6	1.5	1.6	1.5
Price/Cash Flow	11.3	10.5	8.8	8.6	7.5	7.0
Price/Sales	1.6	1.5	1.0	1.0	1.2	1.1
Forecast LT EPS Growth	10.3	9.5	9.7	7.9	11.7	12.1

	Est. P/E Ratio		Est. EPS Growth		Fair Value Returns			Fair Value Returns		
	2014	2015	2014	2015	13x	17.5x	7% DR	13x	17.5x	7% DR
Large	16.3	14.2	16.3	14.2	-20.2	7.5	-12.3	-8.5	23.1	0.5
Mid	19.1	15.9	19.1	15.9	-32.0	-8.5	-25.3	-18.2	10.1	-10.1
Small	20.3	15.6	20.3	15.6	-36.0	-13.9	-29.7	-16.4	12.5	-8.2

Bond Returns And Characteristics For Periods Ending September 30, 2014

	Qtr	Ytd	1 Year	3 Year	5 Year
Nationality					
U.S. Market	0.2	4.1	4.0	2.4	4.1
Developed Intl	-5.4	0.3	-1.1	-1.4	1.2
Emerging Market	-0.6	8.0	9.7	7.9	8.0
Maturity					
Cash	0.0	0.0	0.0	0.1	0.1
Short-Term	0.0	0.6	0.8	0.9	1.5
Intermediate-Term	0.0	2.2	2.2	2.0	3.4
Long-Term	1.0	13.0	12.9	4.7	8.0
Sector					
Corporate	0.0	5.7	6.6	4.8	6.1
Government	0.3	3.0	2.3	1.1	3.1
Mortgage	0.2	4.2	3.8	2.1	3.5
Other					
High Yield	-1.9	3.5	7.2	11.1	10.6
Inflation Protected	-2.0	3.7	1.6	1.3	4.5
Municipal	1.5	7.6	7.9	4.6	4.7

(Returns)

Bond Yields	Qtr	Last Qtr	1 Year Ago
Fed Funds	0.09	0.10	0.08
Prime Rate	3.25	3.25	3.25
3 Month Treasury	0.02	0.04	0.02
1 Year Treasury	0.11	0.10	0.12
3 Year Treasury	1.05	0.90	0.78
5 Year Treasury	1.77	1.68	1.60
10 Year Treasury	2.53	2.60	2.81
30 Year Treasury	3.26	3.42	3.79
Muni Bonds	4.13	4.35	4.79
Mortgage (30-Year)	4.16	4.16	4.49
5 Year TIP	0.10	-0.29	-0.17
10 Year TIP	0.46	0.37	0.66
30 Year TIP	1.05	1.11	1.50
1 Year Inflation	1.58	2.07	1.15
AAA Corporate	2.68	2.51	2.76
BBB Corporate	3.63	3.42	4.03
BB Corporate	4.99	4.30	5.22
High Yield	6.26	5.28	6.47
Emerging Market	2.74	2.62	3.01

10-Year Sovereign Bond Yields

Developed Mkts	Qtr	Last Qtr	1 Year Ago
United States	2.54	2.601	2.71
Canada	2.20	2.26	2.69
France	1.34	1.75	2.51
Germany	1.01	1.38	2.00
Italy	2.37	2.85	4.46
United Kingdom	2.50	3.00	2.83
Euro Zone	1.01	1.38	2.00
Australia	3.61	3.74	4.05
Hong Kong	2.06	2.17	2.33
Japan	0.53	0.60	0.71
Emerging			
Brazil	11.77	11.98	11.52
China	3.93	3.84	3.98
India	8.48	8.67	8.37
Russia	9.30	8.68	7.66

Relative Comparisons

	Qtr	Last Qtr	1 Year Ago
Implied Inflation			
5 Year	1.67	1.98	1.77
10 Year	2.06	2.22	2.14
30 Year	2.19	2.28	2.26
Spreads			
Maturity (10-1yr)	2.42	2.50	2.69
Maturity (30-10yr)	0.73	0.82	0.98
AAA - 10 Yr	0.15	-0.09	-0.05
BBB - 10 Yr	1.10	0.82	1.22
BB - 10 Yr	2.46	1.70	2.41
Municipal	1.60	1.75	1.98
High Yield - 10 Yr	3.73	2.68	3.66
Emerging - 10 Yr	0.21	0.02	0.20

Commodity, Real Estate, & Currency Returns
For Periods Ending September 30, 2014

	Qtr	Ytd	1 Year	3 Year	5 Year
Commodity					
DJ UBS Commodity	-11.8	-5.6	-6.6	-5.3	-1.4
CRB Commodity Spot	-4.6	3.9	1.3	-2.0	4.9
CRB Fat & Oils	-1.8	24.3	2.1	-4.5	9.9
CRB Foodstuffs	-6.3	16.0	5.3	-2.7	6.7
CRB Livestock	-2.4	20.5	6.6	1.1	13.5
CRB Metals	-1.1	-5.1	0.2	0.9	5.7
CRB Raw Industrials	-3.3	-3.8	-1.3	-1.6	3.7
CRB Textiles & Fibers	-5.4	-7.1	-6.9	-5.0	-0.2
Agriculture					
Coffee	6.6	67.3	59.7	-8.4	7.8
Corn	-24.7	-23.4	-37.4	-19.1	0.8
Soybean	-22.2	-13.8	-15.8	-2.8	2.8
Sugar	1.0	26.3	21.4	-12.6	-0.8
Wheat	-11.9	-15.0	-15.9	-8.8	5.0
Energy					
Oil	-11.3	-4.7	-12.2	2.9	6.1
Unleaded Gas	-8.5	2.2	-2.0	-0.9	6.1
Metals					
Aluminum	8.2	14.4	13.0	-4.6	1.6
Copper	0.7	-4.7	-4.0	-6.1	2.1
Gold	-3.1	1.1	-8.2	-11.2	4.4
Nickel	-3.2	29.5	30.7	-4.0	0.7
Zinc	7.8	16.2	24.2	3.4	4.1
Real Estate					
MSCI U.S. Reit	-3.1	14.0	13.3	16.6	16.0
MSCI World Reit	-3.7	6.8	5.8	14.5	10.2
Currency		**U.S. Dollar Returns**			
Euro	5.5	6.4	3.6	2.2	2.5
Japan	5.3	3.8	8.3	11.8	3.3
U.K.	3.8	0.6	-2.5	-1.1	0.0
Brazil	4.6	-0.4	3.3	10.2	5.1
China	-1.5	1.1	0.3	-1.3	-2.1
India	1.9	-1.5	-4.3	8.5	4.7
Mexico	1.9	1.7	1.4	0.4	-0.3

Current Economic & Financial Conditions

	Percent Change					
	3 Month	3 Month Annualized	6 Month	6 Month Annualized	1 Year	Data As Of
Gross Domestic Product	1.1	4.6	0.6	1.2	2.6	June/2014
Leading Economic Indicators	2.0	8.1	3.8	7.7	7.7	August/2014
ECRI Weekly Leading Index	-0.8	-3.0	0.6	1.3	2.2	September/2014
Commercial and Industrial Loans At All Commercial Banks	2.6	10.9	5.3	10.9	12.3	September/2014
Retail Sales	0.4	1.6	1.9	3.8	4.0	September/2014
Retail Sales (Excluding Food Service)	0.4	1.6	1.9	3.8	4.0	September/2014
Real Disposable Personal Income	0.7	2.8	1.8	3.6	2.7	August/2014
Industrial Production	1.1	4.4	1.9	3.9	4.3	September/2014
ISM Manufacturing: Purchasing Managers Index	2.4	9.7	5.4	11.1	1.1	September/2014
4-Week Moving Average of Initial Claims	-6.4	-23.3	-8.1	-15.5	-6.3	September/2014
Hires: Total Private	-2.4	-9.1	-1.2	-2.4	1.1	August/2014
Job Openings: Total Private	6.1	26.6	17.3	37.6	23.4	August/2014
Consumer Price Index	0.0	-0.1	0.8	1.7	1.7	September/2014
Consumer Price Index Less Food and Energy	0.2	1.0	0.9	1.8	1.7	September/2014
New One-Family Houses Sold	10.0	46.6	16.7	36.1	33.0	August/2014
Median Sales Price of Homes Sold	-2.9	-11.1	0.3	0.7	2.8	March/2014
S&P 500 Earnings	2.3	9.3	2.9	5.9	13.4	June/2014
CRB Commodity Spot Index	-4.6	-17.0	-4.0	-7.9	1.3	September/2014
Spot Oil Price (West Texas Intermediate)	13.6	66.7	10.5	22.1	19.0	July/2013
Gold Price	-7.5	-26.8	-5.8	-11.3	-8.3	September/2014

	Actual Value / Diffusion Index				
	Current Value	3 Months Ago	6 Months Ago	1 Year Ago	Data As Of
Phili Fed: General Activity - vs. Prior Month (Diffusion)	22.5	17.8	9.0	20.0	September/2014
Phili Fed: General Activity - 6 Months Ahead (Diffusion)	56.0	52.0	35.4	57.0	September/2014
Chicago Fed: National Activity Index	0.5	0.2	0.5	0.3	September/2014
St. Louis Financial Stress Index	-1.2	-1.5	-1.3	-1.0	September/2014
Loan Officer Net % Tighter Criteria Consumer Loans	-13.0	-9.3	-7.0	-3.6	September/2014
Loan Officer Net % Willingness to Make Consumer Loans	15.7	11.6	15.5	13.0	September/2014
Consumer Sentiment	82.5	81.9	81.6	82.1	August/2014
Manpower Employment Outlook (Net % Hiring)	13.0	13.0	13.0	11.0	August/2014
Unemployment Rate	6.0	6.2	7.0	7.5	September/2014
University Of Michigan Inflation Expectations	3.0	3.1	3.2	3.3	September/2014
AAII Survey: Stock Allocation	66.7	67.0	67.2	64.5	September/2014
AAII Bull/Bear Investor Sentiment Spread	13.6	16.1	2.6	5.4	September/2014
AAII Percent Bullish 8-Week Average	42.2	35.6	37.5	37.3	September/2014
CBOE Volatility Index	16.3	11.6	13.9	16.6	September/2014
3 Month Treasury	N/A	N/A	0.1	N/A	September/2014
1 Year Treasury	0.1	0.1	0.1	0.1	September/2014
5 Year Treasury	1.8	1.7	1.6	1.6	September/2014
10 Year Treasury	2.5	2.6	2.7	2.8	September/2014
30 Year Treasury	3.3	3.4	3.6	3.8	September/2014
5 Year TIP	0.1	-0.3	-0.1	-0.2	September/2014
10 year TIP	0.5	0.4	0.6	0.7	September/2014
30 Year TIP	1.1	1.1	1.3	1.5	September/2014
Bond Buyer 20-Bond Municipal Bond Index	4.1	4.4	4.5	4.8	September/2014
ML BBB	3.6	3.4	3.7	4.0	September/2014
ML High Yield	6.3	5.3	5.6	6.5	September/2014
ML AAA-A Emerging Market	2.7	2.6	2.8	3.0	September/2014

A diffusion index is the difference between the percent of respondents expecting an increase less those expecting a decrease.